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No. 04-1704

IN THE

Supreme Court of the United States

DAIMLERCHRYSLER CORPORATION, ET AL.,

Petitioners,

v.

CHARLOTTE CUNO, ET AL.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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BRIEF OF CENTER ON BUDGET AND POLICY PRIORITIES AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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This brief is filed on behalf of the Center on Budget and Policy Priorities as *amicus curiae* in support of the respondents, with the written consent of the parties lodged with the Clerk of this Court. No counsel for any party authored this brief in whole or in part, and no person other than the *amicus curiae*, its members, or its counsel made a monetary contribution to the preparation or submission of this brief.

INTEREST OF *AMICUS CURIAE*

Founded in 1981, the Center on Budget and Policy Priorities is a District of Columbia non-profit policy institute that conducts research and analysis to inform public debates over state and federal budget and tax policies and to help ensure that the needs of low and moderate-income families and individuals are considered in those debates. The Center is concerned that limited state and local tax revenues that finance public services needed by low-income families and individuals are being given away in the form of often ineffective and unconstitutional tax incentives like the one at issue in this case. Further, state and local tax systems already are largely structured in a manner that imposes disproportionate tax burdens on those at the low end of the income distribution; the Center is concerned that the revenue loss associated with tax incentives such as the one at issue in this case leads to still higher tax burdens for low and moderate-income people as states seek to replace the lost revenue.

SUMMARY OF THE ARGUMENT

The Commerce Clause is necessary for a national economy in which there is a free flow of goods, services and capital among the states. Ohio's Investment Tax Credit discriminates against interstate commerce in that it can result in lower taxes for Ohio firms that invest in new facilities in-state, as opposed to similarly situated Ohio firms that chose to invest in new out-of-state facilities. The system of competing state investment incentives has adverse political and economic effects that violate the letter, spirit and intent of the Commerce Clause. The decision of the United States Court of Appeals for the Sixth Circuit should be affirmed.

ARGUMENT

TO ACHIEVE THE PURPOSES OF THE COMMERCE CLAUSE, IT MUST ENCOMPASS THE INTERSTATE FLOW OF INVESTMENT AS WELL AS THE INTERSTATE FLOW OF GOODS AND SERVICES

One of the important reasons for the Constitution was the need to develop a national economy. Under the Articles of Confederation the states were free to impose tariffs and other restraints on interstate commerce. Economic growth stagnated. Commercial rivalry among the states even raised fears of "serious interruptions of public tranquillity."[1] When the states adopted the Constitution, they gave up their power

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[1] The Federalist No. 42, at 264 (James Madison) (Clinton Rossiter ed., Signet Classic 2003) (1961).

to promote their own economic good at the expense of the nation.[2] In the often quoted words of Justice Jackson,

> Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation, that no home embargoes will withhold his export, and no foreign state will by customs duties or regulations exclude them. Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.

H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525, 539 (1949).

While the temptation to give local enterprise an edge has never disappeared, when states have attempted to favor

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[2] "Under the Articles of Confederation, state taxes and duties hindered and suppressed interstate commerce; the Framers intended the Commerce Clause as a cure for these structural ills." *Quill Corp. v. North* Dakota, 504 U.S. 298, 312 (1992) (citing The Federalist Nos. 7 & 11 (Alexander Hamilton)). It is worth noting that the European Union has to deal with the same issues: see Reuven S. Avi-Yonah, *Passport to Toledo: Cuno, the World Trade Organization, and the European Court of Justice*, 109 Tax Notes 1661 (Dec. 26, 2005); and Lee A. Sheppard, *Self-Inflincted Wounds: What Europe Can Teach the States*, 104 Tax Notes 349 (July 26, 2004).

in-state over out-of-state business, this Court has struck down those schemes as inconsistent with the concept of an open national market.

A national economy encompasses not just the free flow of goods, labor, and services; it must also include the free flow of investment capital. Devices to attract investment capital have an almost irresistible appeal to political leaders at every level. The desire to take credit for new jobs has resulted in the quest for ways to favor local development. The device at issue in this case is an Ohio investment tax credit (ITC) granted to the Petitioner, DaimlerChrysler Corporation. Ohio Rev. Code Ann. § 5733.33. Respondents contend that this tax credit violates the Commerce Clause of the Constitution, Art. I, § 8. The Ohio Petitioners point out that this Court has never struck down an investment incentive analogous to the Ohio tax credit. They claim Ohio's

> tax credit is freely available to all who invest in Ohio, whether already here or new to the State. And unlike a tariff, it does not seek to impose an ongoing burden on those who elect to place their facilities elsewhere. Rather it merely provides a one-time benefit, akin to a subsidy, to those who locate their facility in the State. That is, as its name suggests, it provides *incentives*, not *penalties* . . . .

Ohio Petrs.' Br. 3.

They contend that this Court has invoked the Commerce Clause only against "protectionist tariffs and tax regimes calibrated to the same protectionist ends."

(DaimlerChrysler Petr.'s Br. 26). Therefore, they contend that this case falls outside all of the cases in which this Court has found a violation of the Commerce Clause.

The intent of the Commerce Clause is not so limited.[3] Tariffs and protectionist taxes are wrong not only because of narrow economic considerations, but because they offend the fundamental concept of a national economy. In addition to discriminating against interstate commerce, they result in destructive and wasteful rivalry among the states, they squander valuable resources, create unwarranted windfalls for private interests, interfere with effective policies for economic growth, misallocate investment, distort the tax and budget decisions of the states, and interfere with the normal comity and civility among the states.[4] It is against the standard of a true national economy, in both an economic and political sense, that the tax incentive in question here must be judged.

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[3] *See, e.g., Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997); *Am. Trucking Ass'ns v. Scheiner*, 483 U.S. 266 (1987); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984); *Westinghouse Elec. Corp. v.* Tully, 466 U.S. 388 (1984); and *Maryland v. Louisiana*, 451 U.S. 725 (1981).

[4] Complaints against the economic conditions under the Articles of Confederation included, "the decay of our trade and manufactures–the scarcity of money–the failure of publick credit–the distraction of our publick affairs, and the distress of individuals." *A Political Dialogue*, Massachusetts Centinel (Boston), Oct. 24, 1787, *in The Debate on the Constitution Part One* 189, 190 (Bernard Bailyn ed., Library of America 1993).

THE OHIO INVESTMENT TAX CREDIT VIOLATES THE COMMERCE CLAUSE

Petitioners devote much of their argument to the claim that there are no cases holding that an investment incentive analogous to the Ohio ITC violates the Commerce Clause. The lack of case law on this specific point is hardly a reflection on the state of the law or the merits of this case. It is rather a reflection of economic reality. Courts cannot decide cases when no one brings them. Those in the best position to challenge tax schemes that violate the Commerce Clause are the ones who benefit most from such schemes. A firm believing itself disadvantaged by a tax scheme may well feel better advised to seek the same advantage for itself than challenge the system. As discussed below, the corporate world, in general, has benefited greatly from the competition among the states to grant investment incentives. Likewise, state political leaders may well prefer press releases announcing the creation of "new jobs" to the vindication of the values embodied in the Commerce Clause. Given the incentives, the costs, and procedural obstacles, the real wonder is that there are any Commerce Clause cases at all.

Petitioners contend that an ITC is simply a subsidy, and cite authority for the proposition that a subsidy, even one limited to in-state investment, cannot violate the Commerce Clause. Equating an ITC to a subsidy defies reality and common sense. There is a reason that those seeking or granting investment incentives regularly look to the tax codes and rarely to direct subsidies. Subsidies invoke the political process in a far more direct and specific way. A subsidy must be appropriated by a legislature; it must name an amount and define recipients. The conscious appropriation of the public's money inevitably faces

difficulties and challenges that abstract and arcane changes to a tax code do not. Does DaimlerChrysler ask us to believe that invoking Ohio's ITC was *exactly* the same as going to the Ohio state legislature and asking for a direct subsidy in the amount involved here? Are we to believe that the resulting debate would not have mattered?

However it may be characterized, the Ohio ITC does discriminate against interstate commerce. This can be easily demonstrated using a simple and realistic hypothetical example. (The details are set out in Appendix A.) Assume that two equally situated Ohio firms decide to expand. One firm constructs a new plant in Ohio; the other firm constructs an identical new plant in another state. If the first firm's new plant in Ohio generates enough ITC to eliminate the taxes owed by the preexisting plant, then that firm will owe nothing in Ohio taxes. On the other hand, the firm which expands outside Ohio will continue to owe Ohio taxes on income attributable to its preexisting plant in Ohio and will therefore be at a disadvantage–even if the other state has a tax regime identical to that of Ohio, including an ITC. Thus, Ohio's investment tax credit discriminates against the company that chooses to expand outside the state by imposing a higher income tax burden upon it.

EVEN THOUGH STATE INVESTMENT TAX INCENTIVES ARE RARELY EFFECTIVE, THEY DAMAGE THE NATIONAL ECONOMY

An effort to assess the effect of investment tax incentives on the commerce among the states must take into account four somewhat overlapping features of state investment promotion.

First, it is beyond dispute that the incentives are intended to be effective. Each state intends to promote investment at home and not somewhere else. No state's or locality's incentive is aimed at benefiting the nation's economy as a whole.

Second, such efforts can only be effective on the margin. State and local taxes are only one of a myriad of factors that influence a firm's location decision. Savings from tax incentives are quite small compared to such costs as labor and transportation. Evidence from IRS data suggests that state and local taxes amount to less than 2 percent of total costs for an average corporation.[5] Also limiting the effectiveness of any location incentive is the very pervasiveness of such schemes. If only one state, or very few, were to offer such incentives, the chances of success would be greater than if many or all offered them. As detailed in the Amicus Brief of the Washington Legal Foundation, virtually every state offers some version of an investment incentive.[6] One must also take into account, not only the pervasiveness of these schemes, but the scale of the

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[5] Michael Mazerov, Center on Budget and Policy Priorities, *Should Congress Authorize States to Continue Giving Tax Breaks to Businesses?* 11 (2005), *available at* http://www.cbpp.org/2-18-05sfp.pdf, citing Patrice E. Treubert, IRS, *Corporation Income Tax Returns, 2001*, in *Statistics of Income Bulletin* 138 (Summer 2004), and Robert Cline et al., Ernst & Young, *Total State and Local Business Taxes* (Jan. 2004). *See also* Robert G. Lynch, *Weaknesses in the Common Arguments for State and Local Tax Cuts and Incentives*, 32 State Tax Notes 597, 598 n.1 (May 24, 2004).

[6] Washington Legal Foundation, Amicus Br. Appendix at A-1 *et seq.*

effort they involve. Behind the tax incentive programs in each state is a bureaucratic apparatus devoted to creating and granting such incentives. Comparable activity has developed on the corporate side. Indeed, a veritable industry has grown up around these incentives, backed by a legion of lawyers and accountants. There are even "site location consultants" who work on commission. All of these activities and resources are devoted to the struggle to get firms to locate here and not there.[7] We have what many commentators call a "race to the bottom."

Third, the cost of these schemes is very great. The best estimates place the cost for all the states and local

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[7] Time Magazine has described all this activity vividly:

> If corporate welfare is an unproductive end game, why does it keep growing in a period of intensive government cost cutting? For starters, it has good p.r. and an army of bureaucrats working to expand it. A corporate-welfare bureaucracy of an estimated 11,000 organizations and agencies has grown up, with access to city halls, statehouses, the Capitol and the White House. They conduct seminars, conferences and training sessions. They have their own trade associations. They publish their own journals and newsletters. They create attractive websites on the Internet. And they never call it "welfare." They call it "economic incentives" or "empowerment zones" or "enterprise zones."

Donald L. Barlett & James B. Steele, *Corporate Welfare, Special Report*, Time, Nov. 9, 1998, at 36, 39.

governments combined at between $40 and 50 billion annually.[8]

Fourth, states are not completely irrational; they would not deliberately give away large amounts of resources in a very uncertain effort, except for the belief that such incentives are available elsewhere and that the politics of the situation compels that they be matched. Commentators have frequently noted that the states individually are in a classic "prisoner's dilemma."[9] That is, they would be better off if they cooperated rather than being played off against each other.[10]

In bargaining with the states one at a time, the corporations are well aware of their advantages. Economists have long noted that a disparity in access to information can radically skew the efficient market outcome.[11] In trying to

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[8] Alan H. Peters & Peter S. Fisher, *The Failures of Economic Development Incentives*, 70:1 J. Am. Plan. Ass'n 27, 28 (Winter 2004).

[9] See Graham Bannock et al., *The Penguin Dictionary of Economics* 307-08 (7th ed. 2003), for an extensive discussion of the dilemma.

[10] The "prisoner's dilemma" does not depend on an actual dilemma, but only on the perception that the dilemma exists. In the case at hand, we do not contend that each state actually faces the necessity of providing competing investment incentives. On the contrary, there are more effective and efficient ways to promote investment. The fact that state officials believe themselves to be caught in such a dilemma is reflected in the Amicus Brief of the States at 21.

[11] Joseph E. Stiglitz, Information and the Change in the Paradigm in Economics, Nobel Prize Lecture (Dec. 8, 2001), *available at*

develop its investment incentives, each state faces a serious disadvantage relative to the firms bargaining for the incentives. Justice Jackson's farmers and craftsmen are not the ones on the other side of the table. In 2004, DaimlerChrysler had more employees than the city of Toledo had people – about 70,000 more,[12] and it had total revenue four times the budget for the entire State of Ohio.[13]

At this point, we are left with what appears, on its face, to be a system of competing incentives that produces few if any of the benefits intended by its creators and advocates, but involves massive costs. On the margin, such incentives are no doubt able on occasion to successfully influence a business investment decision. But the effectiveness of the system is undermined by its central feature: a pervasiveness driven by a kind of interstate rivalry that is an affront to the basic intent of the Commerce Clause. Paradoxically, it is the pervasiveness of the system that both sustains it and, at the same time, limits its effects. Petitioners attempt to find a contradiction in the Respondent's allegation that tax incentives are both ineffectual and injurious. Of course, no one would claim that tax incentives are never effective. In those infrequent

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http://www2.gsb.columbia.edu/faculty/jstiglitz/download/2001_Nobel_Lecture.pdf.

[12] DaimlerChrysler Corp., *Company at a Glance - A Truly Global Company, available at* http://www.daimlerchrysler.com/dccom/0,,0-5-7155-1-12898-1-0-0-0-0-0-243-7155-0-0-0-0-0-0-0,00.html.

[13] Office of Budget and Mgmt., State of Ohio, *Budget Highlights - Fiscal Years 2004 and 2005* (2003), *available at* http://www.obm.ohio.gov/budget/operating/executive/0405/highlights0405.pdf.

instances when all other factors balance out, they certainly can tip the decision to locate in the jurisdiction offering the incentive. When they do so, they do harm to the concept of a national market. But this is not the end of it; they are harmful even when they do not succeed in attracting significant new investment. To the extent that one state offers incentives, it inspires similar conduct in other states. The race-to-the-bottom itself is harmful to the concept of a national economy. As in any race, there are more losers than winners.

STATE INVESTMENT TAX CREDITS WASTE SCARCE PUBLIC RESOURCES AND SHIFT THE TAX BURDEN TOWARD LOW AND MODERATE-INCOME HOUSEHOLDS

Petitioners contend that "far from erecting a barrier to interstate commerce, tax credits like Ohio's promote commerce – interstate and intrastate – by spurring competition between the States to create attractive environments for capital investment and economic development." (DaimlerChrysler Petr.'s Br. 10).

This statement simply does not bear close examination. The question of the costs and benefits of investment incentives has produced a vast volume of literature. Two economists who conducted an extensive and scholarly review of this literature concluded:

> The upshot of all of this is that on this most basic question of all–whether incentives induce significant new investment or jobs–we simply do not know the answer. Since these programs probably cost state and local

> government about $40–50 billion a year, one would expect some clear and undisputed evidence of their success. This is not the case. In fact, there are very good reasons–theoretical, empirical, and practical–to believe that economic development incentives have little or no impact on firm location and investment decisions.[14]

The $40–50 billion cost does have an acknowledged impact. It is $40–50 billion that the states and local governments do not have for other purposes including economic development.[15] Ironically, Petitioner DaimlerChrysler contends that this case puts "[a]t risk ... infrastructure improvements, and even perhaps vocational training programs...." (DaimlerChrysler Petr.'s Br. 37). In fact, it is the enormous cost of the tax incentive system that puts these infrastructure and education programs in jeopardy.

The economist, Robert G. Lynch, conducted an extensive review of the econometric literature on tax cuts and incentives for businesses. He finds,

> A review of the hundreds of econometric and representative firm studies that have evaluated the effects of state and

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[14] Peters & Fisher at 32, *supra* note 8.

[15] It is notable that most of the economic studies that find some benefit from location incentives *assume* that the costs of such incentives do not result in a reduction of government services. Robert G. Lynch, *The Effects of State and Local Taxes and Public Services on Economic Development*, 32 State Tax Notes 767, 768 (June 7, 2004).

> local tax cuts and incentives makes clear that those strategies are unlikely to stimulate economic activity and create jobs in a *cost-effective* manner.[16]

More importantly, he concludes,

> Indeed, most econometric studies suggest that public services such as education and infrastructure spur economic growth and influence business location decisions. Hence, as Bartik writes, "[a]n economic development policy of business tax cuts may fail to increase jobs in a state or metropolitan area if it leads to a deterioration of public services to business. An economic development policy of tax increases may succeed in increasing jobs if it significantly improves public services to business. Policy makers must consider both tax and public service effects on business if they are to successfully increase their area's job growth."[17]

The diversion of public resources away from effective business development is not the end of the harmful effects. In Federalist Paper No. 12, Alexander Hamilton expressed the fear that, if the government could not tax commerce, the burden would fall disproportionately on

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[16] *Id.* at 777.

[17] *Id.* at 778, citing Timothy J. Bartik, W.E. Upjohn Institute for Employment Research, *Who Benefits from State and Local Economic Development Policies?* 8-9 (1991).

farmers, that is, the ordinary Americans of that day: "Revenue ... must be had at all events. In this country if the principal part be not drawn from commerce, it must fall with oppressive weight upon land."[18] Over the past two decades the tax burden of state and local government has become increasingly regressive. In a study of 20 of the most industrialized states, Peter Fisher found that "incentive wars have proceeded to the point that state corporate income taxes are on the verge of disappearing in some states, at least with regard to new investment."[19] Making up for this revenue loss has become more and more the burden of lower and moderate income households. Over the last decade the state and local tax burden has become increasingly regressive.[20]

California provides an excellent example of what has happened at the state level. According to the California Budget Project,

> Over the past two decades, the burden of funding state services has shifted from corporate to personal income taxpayers. The personal income tax is expected to provide 49.5 percent of General Fund revenues in 2004-05, up from 35.4 percent in 1980-81. Corporate tax receipts are expected to provide 10.9 percent of General Fund revenues in

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[18] The Federalist No.12, at 91 (Alexander Hamilton), *supra* note 1.

[19] Greg LeRoy, *The Great American Jobs Scam* 173 (2005).

[20] Nicholas Johnson & Daniel Tenny, Center on Budget and Policy Priorities, *The Rising Regressivity of State Taxes* (Jan. 15, 2002), *available at* http://www.cbpp.org/1-15-02sfp.pdf.

> 2004-05, down from 14.6 percent in 1980-81. New, increased, and expanded corporate tax breaks and the 1996 corporate rate reduction are responsible for the decline in the share of state revenues provided by the corporate income tax. Tax reductions enacted between 1997 and 2004 alone will reduce 2004-05 revenues by $7.2 billion.[21]

This, in turn, has had an effect on the progressivity of the tax system:

> In 2002, the most recent year for which data are available, 347,189 taxpayers reported incomes of $200,000 or more. However, 1,334 of these households paid *no* California personal income tax. How did they do it? The largest tax breaks claimed by "no tax" households include enterprise zone tax breaks, the Manufacturers' Investment Credit, Los Angeles Revitalization Zone Credits, and miscellaneous deductions. The number of high income "no tax" returns more than doubled between 1999 and 2002.[22]

The system of competing incentives has another effect that is harder to quantify. It does not show up in the economists' data nor can it be gotten from regression

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[21] California Budget Project, *Who Pays Taxes in California?* 2 (Apr. 15, 2005), *available at* http://www.cbp.org/2005/0504_whopaystaxes2005.pdf.

[22] *Id.* at 3.

analyses or econometric studies. This is the erosion of public confidence in and respect for government and its processes. The number of press accounts reciting the failures of location incentives to justify their cost and live up to expectations are too numerous to dismiss as merely anecdotal. The enthusiastic press coverage of plant openings and new jobs is regularly followed by articles on promises broken and expectations not met.[23] The appearances of the incentive system are not good. In an article about the government incentives for sports facilities, one economist made this general comment:

> Corporate welfare is always unsavory business. The politically connected and high-profile gain at the expense of business owners and consumers who work hard day to day but have no so-called friends in high places. Decisionmaking is shifted from the private sector, which is guided by price and profit signals to meet and create consumer demand, to the public sector, which is guided by politics and the quest for power. Taxes are increased on the many, so that resources can be funneled to a select few . . . .[24]

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[23] Numerous stories of the failure of investment incentives to meet promises are collected in Barlett & Steele at 40, *supra* note 7; and more recently in Greg LeRoy, *supra* note 19. In no area has the failure of investment incentives to deliver promised benefits been more conspicuous than in the promotion of sports facilities.

[24] Raymond J. Keating, *You're Out! Corporate Welfare for Major League Baseball*, 91 Tax Notes 1739, 1753 (June 4, 2001).

INTERSTATE TAX COMPETITION DAMAGES COMITY AMONG STATES

The fierce competition among the states for jobs and investment has eroded the normal comity among the states. The ill will between California and Nevada has reached the level of radio ads and billboards seeking to lure business away from each other. A recent editorial in the Los Angeles Times on the current tax feud was captioned "A Crooked Game in Nevada."[25] The struggle between Maryland and Virginia over the location of the Marriott International headquarters became exceptionally nasty, particularly after Maryland gave Marriott around $40 million to stay in Maryland, only to learn that the firm's flirtation with Virginia was simply a ploy to raise Maryland's bid.[26] But perhaps the worst behavior came from the Michigan legislature, which just this December passed a new tax incentive which is expressly limited to firms that could show that the new jobs in Michigan were taken from other states.[27] It is not coincidental that discussions of interstate tax competition often reference the conflagration that nearly tore our nation apart.[28]

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[25] Sept. 27, 2005, at B12.

[26] Jay Hancock, *Marriott Used Va. as Ruse to Raise Md. Bid; Public Records Suggest Bethesda Firm's Threat to Leave Was Bluff*, Baltimore Sun, Mar. 27, 1999, at 1A.

[27] Public Act 293, Public Acts of 2005. The Governor approved it on December 20, 2005 and it was filed with the Secretary of State on the same day.

[28] *See, e.g.*, Melvin L. Burstein & Arthur J. Rolnick, *Congress Should End the Economic War Among the States, in* Federal

CONCLUSION

The Ohio ITC violates the Commerce Clause of the Constitution. It discriminates against interstate commerce, contributes to a system of discriminatory tax competition which is inconsistent with the concept of an open national economy, and coerces in-state investments to the detriment of the national economic well-being. It contributes to unhealthy rivalry and animosity among the states, which the Constitution sought to mitigate.

We respectfully request this Court to affirm the decision of the United States Court of Appeals for the Sixth Circuit.

Dated: January 23, 2006

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Reserve Bank of Minneapolis, Annual Report (1994), *available at* http://minneapolisfed.org/pubs/ar/ar1994.cfm.

APPENDIX

Ohio's Investment Tax Credit Discriminates Against an Out-of-State Investment by a Firm Taxable in Ohio, Even If the Other State Has a Corporate Tax Structure Identical to Ohio's

It is easy to demonstrate that in a typical corporate expansion scenario, Ohio's Investment Tax Credit (ITC) discriminates against an out-of-state investment by a firm already taxable in Ohio *even if the other state into which the investment might be placed has an identical ITC and a corporate income tax structure otherwise identical to Ohio's.*

Consider competitors XYZ Corp. and ABC Corp., both of which have a $10 million facility in Ohio and are contemplating a new $5 million facility to serve new markets outside of Ohio that the companies have identified. Both are deciding whether to build the new plant in Ohio or in Other State. Assume that the nationwide sales of the two competitors are currently $10 million, that their sales in both Ohio and Other State are $1 million, that the payroll at the existing plants is $3 million, and that the nationwide profit of both corporations is $1 million annually. Assume that the proposed 50 percent expansion of the firms' asset base will result in a corresponding 50 percent increase in their nationwide sales, payrolls, and profits. Assume that the expansion will generate no additional sales in Ohio or Other State. Note that Ohio gives a three-fifths (60 percent) weight to the sales factor in its corporate income tax apportionment formula, that its corporate income tax rate is 8.5 percent (ignoring the lower rate on the first $50,000 of taxable income for the sake of simplifying the example), and that only one-seventh of the 13.5 percent investment tax credit available in distressed areas may be claimed each year.

Assume that Other State has a corporate tax structure and ITC identical to Ohio's. Assume that both corporations are taxable in Other State notwithstanding a lack of physical presence there because their employees visit from Ohio and engage in activities in Other State that remove the corporate income tax immunity conferred by Public Law 86-272, 15 USC Sections 381-4. Finally, assume that the Ohio plants of both companies are sufficiently old that the original ITC available in connection with the investment in the plants has been fully claimed.

XYZ Corp. Builds New Plant in Ohio

XYZ Corp. expands in Ohio. The financial statistics relevant to its corporate income tax apportionment calculations in Ohio and Other State are as follows:

	Property	Payroll	Sales
Ohio	$10,000,000 old plant $5,000,000 new plant	$3,000,000 old plant $1,500,000 new plant	$1,000,000
Other State	$0	$0	$1,000,000
Everywhere	$15,000,000	$4,500,000	$15,000,000

XYZ's profit taxable by Ohio:

$$= \$1{,}500{,}000 * \left[\frac{\left(\frac{\text{property of XYZ in Ohio}}{\text{property of XYZ everywhere}}\right) + \left(\frac{\text{payroll of XYZ in Ohio}}{\text{payroll of XYZ everywhere}}\right) + 3 * \left(\frac{\text{sales of XYZ in Ohio}}{\text{sales of XYZ everywhere}}\right)}{5} \right]$$

$$= \$1{,}500{,}000 * \left[\frac{\left(\frac{\$15{,}000{,}000}{\$15{,}000{,}000}\right) + \left(\frac{\$4{,}500{,}000}{\$4{,}500{,}000}\right) + 3 * \left(\frac{\$1{,}000{,}000}{\$15{,}000{,}000}\right)}{5}\right]$$

$$= \$1{,}500{,}000 * \left[\frac{1.00 + 1.00 + 3 * .067}{5}\right]$$

$$= \$1{,}500{,}000 * .44$$

= $660,000 (taxable income apportioned to Ohio)

Tax liability to Ohio before investment tax credit = $660,000 taxable income * .085 = $56,100

Investment tax credit = ($5,000,000 new plant * .135 credit)/7 = $96,429

Since the investment tax credit exceeds the pre-credit liability and is non-refundable, XYZ Corp.'s tax liability to Ohio is $0 in the first year if it makes the new investment in Ohio.

XYZ's profit taxable by Other State:

$$= \$1{,}500{,}000 * \left[\frac{\left(\frac{\text{property of XYZ in Other State}}{\text{property of XYZ everywhere}}\right) + \left(\frac{\text{payroll of XYZ in Other State}}{\text{payroll of XYZ everywhere}}\right) + 3 * \left(\frac{\text{sales of XYZ in Other State}}{\text{sales of XYZ everywhere}}\right)}{5}\right]$$

$$= \$1{,}500{,}000 * \left[\frac{\left(\frac{\$0}{\$15{,}000{,}000}\right) + \left(\frac{\$0}{\$4{,}500{,}000}\right) + 3 * \left(\frac{\$1{,}000{,}000}{\$15{,}000{,}000}\right)}{5}\right]$$

$$= \$1{,}500{,}000 * \left[\frac{0 + 0 + 3 * .067}{5}\right]$$

$$= \$1{,}500{,}000 * .04$$

= $60,000 (taxable income apportioned to Other State)

Tax liability to Other State = $60,000 taxable income * .085
= $5,100

ABC Corp. Builds New Plant in Other State

XYZ Corp.'s competitor, ABC Corp., decides to build *its* new plant outside of Ohio, in Other State. Recall again the simplifying assumption that neither company will have new customers in Other State. The financial statistics relevant to the apportionment calculation now are as follows:

	Property	Payroll	Sales
Ohio	$10,000,000 old plant	$3,000,000 old plant	$1,000,000
Other State	$5,000,000 new plant	$1,500,000 new plant	$1,000,000
Every where	$15,000,000	$4,500,000	$15,000,000

ABC's profit taxable by Ohio:

$$= \$1{,}500{,}000 * \left[\frac{\left(\frac{\text{property of ABC in Ohio}}{\text{property of ABC everywhere}} \right) + \left(\frac{\text{payroll of ABC in Ohio}}{\text{payroll of ABC everywhere}} \right) + 3 * \left(\frac{\text{sales of ABC in Ohio}}{\text{sales of ABC everywhere}} \right)}{5} \right]$$

$$= \$1{,}500{,}000 * \left[\frac{\left(\frac{\$10{,}000{,}000}{\$15{,}000{,}000} \right) + \left(\frac{\$3{,}000{,}000}{\$4{,}500{,}000} \right) + 3 * \left(\frac{\$1{,}000{,}000}{\$15{,}000{,}000} \right)}{5} \right]$$

$$= \$1{,}500{,}000 * \left[\frac{.667 + .667 + 3 * .067}{5} \right]$$

$$= \$1{,}500{,}000 * .307$$

= $460,000 (taxable income apportionable to Ohio)

Tax liability to Ohio = $460,000 * .085 (corporate tax rate) = $39,100

ABC's profit taxable by Other State:

$$= \$1{,}500{,}000 * \left[\frac{\left(\frac{\text{property of ABC in Other State}}{\text{property of ABC everywhere}} \right) + \left(\frac{\text{payroll of ABC in Other State}}{\text{payroll of ABC everywhere}} \right) + 3 * \left(\frac{\text{sales of ABC in Other State}}{\text{sales of ABC everywhere}} \right)}{5} \right]$$

$$= \$1{,}500{,}000 * \left[\frac{\left(\frac{\$5{,}000{,}000}{\$15{,}000{,}000} \right) + \left(\frac{\$1{,}500{,}000}{\$4{,}500{,}000} \right) + 3 * \left(\frac{\$1{,}000{,}000}{\$15{,}000{,}000} \right)}{5} \right]$$

$$= \$1{,}500{,}000 * \left[\frac{.333 + .333 + 3 * .067}{5} \right]$$

= $1,500,000 * .1733

= $259,950 (taxable income apportioned to Other State)

Tax liability to Other State before investment tax credit = $259,950 taxable income * .085 = $22,096

Investment tax credit = ($5,000,000 new plant * .135 credit)/7 = $96,429

Since the investment tax credit exceeds the pre-credit liability and is non-refundable, ABC Corp.'s tax liability to Other State is $0 in the first year if it makes the new investment in Other State. However, it remains liable for $39,100 of tax in Ohio.

Conclusion: Investment Tax Credit Discriminates Against Interstate Commerce

If XYZ Corporation builds its new plant in Ohio, its total Ohio state tax liability in the first year of the investment is $0. Not only does the ITC offset the entire increase in its Ohio tax liability arising from the increase in its Ohio apportionment factor arising from the additional property and payroll it has placed in Ohio, but it is able to use some of the investment tax credit to completely eliminate the portion of Ohio tax liability attributable to its preexisting activity in the state. XYZ's total tax liability in the two states is $5,100, because it remains liable for tax in Other State, where it has no ITC to claim.

If XYZ's identically-situated competitor, ABC Corp., chooses to build *its* new plant in Other State, while it has no

tax liability to Other State due to Other State's investment tax credit, it remains liable for the full amount of its Ohio tax liability, $39,100. This is more than seven times the total tax liability of its competitor, XYZ.

In short, under a realistic scenario of a 10 percent return on assets and a realistic, 50 percent expansion of production capacity, Ohio's investment tax credit is biased against a cross-border expansion and, hence, against interstate commerce. A multi-year analysis yields the same conclusion; the ITCs available to the two companies in both states are sufficiently large to replicate the first-year results for 10 years, at which point the allowed "carryforward" of the ITC expires.